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SENSITIVE
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SUBJECT: CONCERNS ON UKRAINE'S 2009 BUDGET DEFICIT

REF: KYIV 1557

SENSITIVE BUT UNCLASSIFIED, NOT FOR INTERNET DISTRIBUTION

¶1. (SBU) Summary. Extensive government manipulation of the budget and coerced advance payment of corporate taxes have kept Ukraine in the black so far this year, but revenue from these measures is exhausted and the Government of Ukraine (GOU) has numerous outlays in the balance of the year. Analysts project that if current revenue and expenditure projections remain, the GOU will face a 9.2% of GDP deficit, without any clear source of financing beyond (still uncertain) IFI loans. In the absence of external financial support, analysts speculate that Kyiv authorities will rely particularly on monetization by the National Bank of Ukraine (NBU), since the ability to generate revenue in other ways is limited. While the economic crisis has made local budgets more dependent on transfers from the central budget, oblast and municipal leaders complain that the Ministry of Finance is squeezing the localities by delaying payments. End summary.

GOU REPORTS REVEAL FALSE PARITY

¶2. (SBU) Tax and non-tax revenues for the first seven months of 2009, according to recently released data by the GOU, totaled UAH 115.8 billion (roughly $14.5 billion). This figure was 6.2% lower than over the same period last year, a relatively small drop given GDP declines of 20.3% and 18%, respectively, in the first and second quarters of this year. The GOU achieved these revenue figures by forcing pre-payment of taxes and by extensively manipulating non-tax revenues. Such tactics have left Ukraine's budget in a dire situation for the balance of 2009, with the government now unable to cover the gaps that are emerging.

¶3. (SBU) Reports of near parity between expenditures and revenues for the first seven months of 2009 do not reflect the projected annual deficit. The IMF and other local budget analysts continue to foresee a deficit of 6.5% of GDP, excluding financing necessary for Naftohaz and bank recapitalization, which reaches UAH 55 billion ($7 billion) and in large part must be financed over the balance of ¶2009. Budget estimates that include financing needs for Naftohaz and bank recapitalization raise the projected deficit to 9.2% of GDP.

¶4. (SBU) The IMF has already provided Ukraine with $4.8 billion in budget support from its second and third loan tranches. Absent another IMF loan tranche dedicated to the budget or World Bank DPL fiscal support (both of which could be held up by GOU noncompliance with required prior actions), Ukrainian authorities find themselves with few financing options. This has raised fears in the business community that the government will continue to use coercive means to extract payments. It has also raised alarms about the possibility of monetization of the outstanding deficit.

MANIPULATION AND EXTORTION OF TAXES

¶5. (SBU) The decline of tax revenues in the first half of 2009 would have been more severe had the GOU not required companies to pay enterprise profits taxes in advance. We have heard reports that most major companies were forced to pay their annual enterprise profits taxes in the spring and summer months of 2009, more than half a year before such taxes would have been due under more normal circumstances.

¶6. (SBU) A senior partner in a Kyiv-based law firm told us that many of his business clients had been tacitly threatened with visits from the tax inspector or had been hit with trumped up fines for various code violations. He indicated that most businesses had complied with GOU requests for advanced tax payments rather than face ongoing legal hassles.

¶7. (SBU) The American managing director of a major manufacturing plant told us on September 18 that his firm had been visited repeatedly by tax authorities in recent weeks. He said the tax inspector had told him each business in Ukraine was assigned a "fine quota" and that authorities were expected to deliver this amount before the end of the year. The American apparently was told that he could hand over a UAH 150,000 fine on the spot for non-existing violations, or else he had go to court to protest UAH 2 million taxes supposedly evaded, but "either way he would have to pay." The American manager said the entire story had been made up by the inspector and could not be justified by the company's financial paperwork. Ukrainian colleagues were fearful of non-compliance, he commented, and had no trust in the legal system to resolve the case.

¶8. (SBU) State-owned companies have also been affected. Forced to cover much of the GOU's revenue shortfall, energy monopoly Naftohaz transferred UAH 19.2 billion (roughly $1.95 billion) in taxes to the budget in the first half of 2009. This amounted to a 45.8% increase over the same period last year, constituting roughly 20% of Ukraine's budget revenue for the first half of 2009. In previous years, Naftohaz's tax payments had corresponded to about 10% of the state budget revenue. Given Naftohaz's receipt of subsidies and recapitalization funds, however, most analysts suspect its tax payments amounted to a financial shell game.

2009 TAX REVENUE STRUCTURE

¶9. (U) Ukraine relies on various tax sources for nearly 75% of budget revenues. Major taxes include VAT (40% of the budget revenue), enterprise profits tax (20%), import duties (6%), and excise duties on tobacco, alcohol, petroleum products, and transportation (6%).

¶10. (U) The country's sharp economic downturn has resulted in a 13.4% decline in tax revenue in the first seven months of 2009, year-on-year. Import duties fell the most dramatically (down 54%), followed by a 19% decline in revenue from the enterprise profits tax, and 14% decline in revenues from the value added tax (VAT).

¶11. (U) The only sources of increased tax revenue in 2009 resulted from IMF-supported legislation on excise duties on alcohol and cigarettes, which grew for both imported and domestic goods by 39% and 54%, respectively, though the total net effect of these revenues was a fairly negligible UAH 3.5 billion ($430 million).

GOU COOKS (NON-TAX) REVENUE BOOKS

¶12. (U) Non-tax revenues sources are estimated to be roughly 25% of total state budget revenues in 2009. The most important of these are rent fees and profits from government business activities, equaling 40% of non-tax revenues and 10% of total revenues. Within this category, the most important sources are profits from the National Bank of Ukraine (NBU) and fees levied on oil and gas producers. Ukraine receives other non-tax revenues from

administrative fees (such as the issuance of passports), land sales, and special energy-related surcharges.

¶13. (SBU) Declining tax proceeds have been offset by increasing non-tax revenues, which grew 20% in first half of 2009, y-o-y. These increases were almost entirely the result of creative accounting. For example, the Ministry of Finance included a UAH 4 billion ($90 million) sovereign-guaranteed loan for state transportation monopoly Ukravtodor in its 2009 revenue indicators.

¶14. (SBU) The GOU also forced the NBU to transfer UAH 4 billion of its future profits, calculating that the central bank would earn at least this amount from its financing operations. Instead, NBU Governor Stelmakh recently reported that the central bank will only earn UAH 600 million in profits, entitling it to roughly UAH 3.4 billion in refunds. Stelmakh made his statement in light of a Rada (Ukraine's parliament) plan to force the NBU to pay another UAH 9.8 billion for Euro 2012 infrastructure projects, money that was to have been debited against further 2009 profits (reftel).

LOCAL DEPENDENCY INCREASES

¶15. (SBU) Local revenue sources also have been burdened this year. Localities typically rely on transfers from the central government for 40% of their revenues. Failure by state treasury authorities to provide transfers has left local budgets facing unfunded mandates, creating a relationship of even greater dependence on the central government. Localities have very limited spending discretion, as over 80% of expenditures fund so-called protected articles, including social payments and public sector wages, as well as funding for hospitals and schools.

GOU MASSAGES TREASURY ACCOUNT

¶16. (SBU) The single treasury account, which services central and local government revenues, has dipped to historic lows in 2009, falling to levels around UAH 1.5 billion prior to the May and August IMF loan disbursements. The paucity of cash is linked to falling 2009 revenues (which, in turn, resulted from a collapse in GDP and industrial output), as well as to the GOU's allocation of roughly $1 billion for Pension Fund and Naftohaz deficits.

¶17. (SBU) Regional officials, such as Sumy Governor Mykola Lavryk, have blamed the state treasury account's low cash balance for delays in transfers from the central government to localities. In a formal press statement, the Cherkasy mayor likewise maintained that the state treasury had "frozen" payments to municipalities, in order to accommodate cash imbalances in the state budget.

HRYVNIA EMISSION INEVITABLE

¶18. (SBU) There is little appetite, either internationally or domestically, for GOU debt, depriving the government of the option of issuing bonds to cover its deficit. As a result, to cover the budget shortfall, the GOU has returned to its practice of monetization. Via the issuance of treasury bills that are purchased by the NBU, the government has monetized roughly UAH 25 billion ($3 billion) in 2009. The NBU now holds about 48% of all domestic treasury bills, equaling UAH 33.8 billion ($4 billion). Its total holdings constitute a four-fold increase over 2008.

COMMENT

¶19. (SBU) Despite its dire budget situation, the GOU has not made any spending cuts in 2009. Rather, with the aid of the IMF's loans, it has increased budget expenditures by 6.4% in the first seven months of 2009, y-o-y. Even with another loan tranche that would be dedicated to the budget, a policy position not normally adopted by the IMF, the GOU would still have trouble meeting its growing fiscal

obligations, let alone face the external commitments that will come due in 2010 after massive corporate roll-overs this year.

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